

WHAT COULD CAGE THE BEAR; An aggressive Fed can blunt its bite. And so can foreign investors in search of bargains

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February 4, 2008

Bear markets are always difficult to predict, but this one is straight out of The Twilight Zone. Barely a year ago, market watchers were wringing their hands over the reckless ascent of Chinese stocks; the profligate bond terms being extended to banana republics; the lust for all things emerging market. Surely, said the experts, a snafu in some far-flung place would bring the global stock market bull to its knees. The U.S., of course, would be the redoubt of quality.

Not quite. Foreign markets are swooning all right, but on fears over what's happening stateside. The supposedly steady U.S. market has been a basket case, dipping on Wednesday morning to 19% below its October high. (O.K., quibble if you must that the bear market threshold is 20%. But what's a percentage point among friends?) Despite the midweek rally, stocks are down a sickening 9% for the year.

This is what you need to know: We're in a bear market. Bear markets are painful. Some end quickly, others grind on for years. There's little use trying to predict what will happen or when, because full recoveries are apparent only in hindsight. Selling can be just as risky as buying, because there's no telling when an explosive rally will add 500 points to the Dow Jones industrial average in a day. Oh, and there are head fakes that will break your heart. (Like Wednesday's rally, perhaps.) "Personally, I don't think the real selling has even begun," says Robert Arnott, chairman of Research Affiliates, a Pasadena (Calif.)-based asset management shop. "The market only now realizes how seriously overexposed it was to loans and securities that should never have been made."

CONFUSION REIGNS

More worrisome, the sell-off is being driven by the so-called smart money--professional investors who manage big sums. This is no time, say some advisers, for retail investors to try to trade in and out of the swings. "It's a treacherous landscape," says Chris Whalen of Institutional Risk Analytics, a risk management consultancy. "The little guys always get hurt when they try to outguess the market." Some advisers think retail investors should ignore all of the old nostrums right now. "Buy and hold' should be thrown in the dustbin," says Steven Lehman of Federated Investors, who predicts the stock market slump will last "for the foreseeable future."

But tempting though it may be to give in to the gloom, January isn't a foolproof predictor

of things to come. The five worst January swoons since 1926 led to an average gain of 12.3% over the following 12 months and 26% over the next 24 months. What's more, bear markets often produce big gains down the road.

For now, confusion reigns as pros grapple with the snarling bear. Some, like Scott Armiger of Greenville (Del.)-based Christiana Bank & Trust, are sticking with textbook responses to slowdowns: buying into defensive sectors such as consumer staples and health care.

Others are tweaking their approaches based on the global economy. John Boich of Security Global Investors and Paul Blankenhagen of Principal Global Investors both figure a U.S. slowdown will crimp growth overseas. Blankenhagen has been exiting European retail stocks and other companies exposed to consumers. Boich is looking for investments that will be insulated from a global slowdown, such as Hong Kong real estate and Japanese regional banks. Japan, he notes, is nearly through its housing bust and isn't facing the same credit crunch as in the U.S. And India has a domestic growth story: It doesn't rely only on exports to the U.S. "For those who missed India the first time around, take a close look right now," he says.

Some pros are betting on the turmoil itself. Erick Maronak, chief investment officer at Victory Capital Management, is buying shares of CME Group, the parent of the giant Chicago futures exchange. The stock is down 17% on the year, but "the exchanges are one of the more solid places in finance, because they don't have any capital exposure," he says. Plus, they benefit from higher trading volumes during market turmoil.

Then there are the true bears. "I've been saying cash is king for the better part of two years," says Bob Rodriguez of investment manager First Pacific Advisors. "Some stocks are getting attractive, but this crisis is without precedent. It's going to take more time and considerably more contraction in share prices [before we start buying]." He has upped his cash position in the FPA Capital Fund from 35% to 43% this year.

So what might pull the U.S. out of the bear's maw this time? A good guess is that an aggressive Federal Reserve and quickening globalization will somehow point the way forward. But the prices to be paid for the next bull run could be steep.

Start with the Fed, which has been coming to the stock market's rescue for decades. Its first goal right now is to ease the credit crunch. "A credit jam does not get cleared overnight," says economist Edward Yardeni of Yardeni Research. In theory, as the Fed keeps knocking down the short-term rates it charges to banks, those banks will find the cheap money impossible to resist--as will the companies being offered cheaper loans by banks. In a classic scenario, that would kickstart economic growth and send stock prices higher. The question is whether it will work now, amid the worst credit squeeze in memory. The good news? Corporate loan rates are starting to move in the right direction. The most creditworthy companies are able to borrow at less than 5.3%, compared with 5.6% a year ago.

Rate cuts can also help make stocks look more attractive. Investors have poured into Treasuries to a degree not seen since the 2001 terror attacks: The yield on the 10-year bond, which moves inversely to its price, plunged to 3.28% on Jan. 23, its lowest since 2003, from 5.2% in July. The two-year note, meanwhile, now yields a piddling 2%. Factor in inflation and taxes, and Treasury holders are either losing money in real terms or clearing just pennies.

At some point those thin returns will prod investors to move up the risk curve again. Perhaps soon. The "earnings yield" of the Standard & Poor's 500-stock index--that is, the total earnings divided by the price--is 6.5% right now, roughly double the yield of the 10-year Treasury. "Even if you slash profit estimates, what the market is yielding in earnings is drastically superior," says John Schloegel, vice-president of investment strategies for Capital Cities Asset Management. Marc Reinganum, a portfolio manager and director of quantitative research at Oppenheimer Main Street Fund, says that while last year was a time to flee risk, conditions are changing. "When things look most dire, the opportunity is greatest," he says. He expects his riskier bets to pay off "at the midyear period."

FOREIGNERS' SPENDING MONEY

There's just one problem: If Fed Chairman Ben S. Bernanke pushes rates too low, he risks sparking inflation. And with oil prices remaining stubbornly high, rarely has inflation loomed as large over rate cut decisions as it does now. "There's no such thing as a free lunch," said Donald Luskin of advisory firm Trend Macrolytics in a note to clients after Tuesday's rate cut. "And there's no such thing as a free bailout, either. Inflation is the price of this one." Inflation, of course, eats away at real asset returns, canceling out some of the gains of a bull market. One telling sign that it's a concern: The price of gold, the traditional hedge against rising prices, spiked on the day the Fed announced its interest rate reduction.

The lower rates could benefit the stock market in another way: by making the dollar even cheaper relative to other currencies. So far the weak dollar has boosted U.S.-based multinationals such as Coke and IBM, which have generated strong earnings even as corporate profits as a whole have slumped. Strong earnings buoy share prices; Coke and IBM have fallen just 4% and 2% this year, respectively.

A weaker dollar also gives foreigners more spending money in the U.S., enticing them to step in and buy relatively cheap U.S. assets. According to Thomson Financial, foreigners plowed just under half a trillion dollars into American companies last year--nearly double 2006's total. The pace accelerated in January: Foreigners accounted for more than half of all M&A deals. Over time that could be a boon for stock prices. Then again, many Americans would bristle at the prospect of foreigners swooping in to buy a broad swath of U.S. assets.

In the past, other central bankers might have been persuaded to join forces with the Fed to cut rates in lockstep so the dollar could stay relatively stable against the major

currencies. That seems less likely now. On Jan. 23 European Central Bank President Jean-Claude Trichet warned that he still considers inflation a problem. "I trust that in all circumstances, but even more particularly in demanding times of significant market correction and turbulences, it is the responsibility of the central bank to solidly anchor inflation expectations," he said. The subtext: Don't expect major rate cuts in Europe.

For better or worse, the trade-off for the next bull market could be that the U.S. turns into a happy hunting ground for foreign players. "Everything is very global," says Scott Martin, managing director of investments for Chicago-based Astor Asset Management. "There is a lot of money out there."

AFTER THE PAIN

How the Dow has fared during recessions--and the year following those recessions.

Period	Change during recession	Change one year after
August 1929-March 1933	-84.20%	81.07%
May 1937-June 1938	-23.18	-2.43
February 1945-October 1945	21.33	-9.35
November 1948-October 1949	-0.12	18.71
July 1953-May 1954	21.57	29.73
August 1957-April 1958	-9.95	36.83
April 1960-February 1961	7.48	6.94
December 1969-November 1970	-1.36	4.69
November 1973-March 1975	-19.04	30.11
January 1980-July 1980	11.51	1.82
July 1981-November 1982	7.40	22.78
July 1990-March 1991	1.15	11.04
March 2001-November 2001	-5.73	-9.70

Data: Thomson Financial